

## POLICY RESEARCH WORKING PAPER

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# Beyond Unequal Development

## An Overview

*Andrés Solimano*

Development theory from the 1940s through the 1960s emphasized market failures, discontinuities, irreversibilities, and excessive social inequality. In the 1980s and 1990s the emphasis shifted to economic growth supported by the trinity of stabilization, liberalization, and privatization. But increasing problems of social inequality hamper economic growth and the sustainability of development. It is time, says Solimano, to rethink the development paradigm.

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## Summary findings

In the 1980s and 1990s, economic growth (material progress) became the main development goal under the policies known as the "Washington Consensus." Earlier concerns about inequalities of income and wealth were replaced by policies emphasizing macroeconomic stabilization (reducing inflation and cutting fiscal deficits) and structural reform (trade liberalization, financial deregulation, privatization, and a shift to a smaller state). But fiscal adjustment and market liberalization alone have not brought stable, equitable development. Inequality of income and wealth, far from declining, seem to have increased in Latin America.

The "Washington Consensus" has supported social policies that rely on targeting, growth-led poverty reduction, and delivery of social services partly through the private sector. Loose ends to this strategy include:

- Growth patterns that favor skilled labor and nonlabor factors of production.
- The exclusion of vulnerable groups for whom the market produces little income.
- Overreliance on commodity-based growth for human development.
- Political manipulation of beneficiaries and weak institutional ability to reach targeted groups.
- Higher quality services provided by the private sector to high-income and upper-middle-class groups and

lower quality services provided by the state to lower-income groups.

Social policies in developing countries in the past decade have been defined largely in terms of poverty reduction. Solimano argues that income distribution and the reduction of social inequality are valid policy targets on their own. Empirical evidence and theories of endogenous growth emphasize complementarities between social equity and growth. To the extent that social inequality engenders social conflict, invites taxation of physical investments, and induces economic populism, it hampers economic growth. Social policies to promote equitable development should include:

- Good, broad-based education and health services.
- Greater access to credit by low-income households and small-scale producers.
- More equal access to land and ownership of capital stock (say, after privatization).

Social safety nets are needed when unemployment, wage cuts, and declining income threaten the poor. Austerity policies without such safety nets as emergency employment programs, food distribution to children, and minimum income support schemes unduly hurt the poor, the vulnerable, and the politically weak, making fiscal retrenchment difficult and socially regressive.

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This paper — a product of the Colombia, Ecuador, Venezuela Country Management Unit, Latin America and Caribbean Region — will appear in Andrés Solimano, Eduardo Aninat, and Nancy Birdsall, eds., *Distributive Justice and Economic Development* (University of Michigan Press, 1999, forthcoming). Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Andrés Solimano, room I4-051, telephone 202-458-7671, fax 202-676-0720, Internet address [asolimano@worldbank.org](mailto:asolimano@worldbank.org). Policy Research Working Papers are also posted on the Web at <http://www.worldbank.org/html/dec/Publications/Workpapers/home.html>. March 1999. (32 pages)

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# ***Beyond Unequal Development: An Overview***

***by  
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## **Beyond Unequal Development: An Overview**

**Andrés Solimano**

### **Introduction**

In the 1940s, 1950s and 1960s development theory emphasized market failures, discontinuities, irreversibilities and excessive social inequality. The dominant development paradigm stressed the need for the state to create the adequate physical infrastructure, institutional and social conditions for development. This would entail implementing large scale public investment programs, planning and policies aimed at social modernization such as education, health, social protection and housing policies.

In the 1980s and 1990s, this paradigm changed. Development problems were, in a way, reduced to growth problems; and the lack of sustained growth, particularly in the 1980s in Latin America, were described to obey, largely, to pervasive state interference in the market process both internationally through trade protection and nationally through overregulation of goods, capital and labor markets and extended state-ownership of national productive assets.

Economic growth (material progress) became the main development goal in the policies known as the Washington Consensus. Growth was to be supported by (i) macroeconomic stabilization —understood basically as reducing inflation and cutting down fiscal deficits, (ii) structural reform policies viewed as trade liberalization, financial deregulation, privatization and a decisive shift to a smaller state.

Previous concerns of development policy on reducing inequalities of income and wealth were eschewed in favor of an agenda dominated by macro stabilization and liberalization. The experience of the 1990s is showing that the combination of fiscal adjustment and market

liberalization, although necessary policy steps to reduce macro-imbalances and increase efficiency, are insufficient to bring about stable and equitable development. Reality is showing several difficulties of the adjustment and development process underestimated by the policies of the Washington Consensus, say: (i) The transition from low inflation to sustained growth and development is often long; (ii) an excessive emphasis on fiscal adjustment neglected the risks of premature financial liberalization, (iii) globalization has increased the frequency, scope and severity of financial and macro crisis, (iv) governance problems reflected in corruption, dysfunctional institutions and social conflict and are more pervasive than expected, (v) poverty is persistent and positively correlated with macro crisis, (vi) inequality of income and wealth both across and within countries is far from declining, on the contrary it seems to have increased in the last decade or so in Latin America.

Addressing these issues may call for a rethinking of existing development paradigms. This chapter focuses on one, but important, dimension of the development process—namely inequality—and asks how we can move beyond the trap of unequal development. For that purpose, this chapter reviews, selectively, two stands of literature pertaining to our subject. (i) The recent developments of distributive justice that provides an inter phase between the political philosophy of justice and the economics of income distribution and social welfare; (ii) the analytics and empirics of the relationship between inequality and growth. The underlying idea is that more egalitarian development is feasible and desirable and that positive complementarities can be found between distributive justice, social equity and economic development.

Then, this chapter turns to social policies. The discussion continues by identifying policies compatible with both rapid growth and more egalitarian development. Structural social policies, emergency social safety nets and policies to foster egalitarian access to wealth-creation

processes and assets (e. g. education, credit, ownership of productive assets). The scope and limits of targeting, growth trickle-down and private provision of social services are also reassessed as foundations for social policies behind the Washington Consensus.

### **I. Poverty and Inequality: What Do We Mean by Social Equity?**

A minimalist approach views the reduction of absolute poverty as the only valid concern for social policy. Public policy must assure that most of (ideally all) the population is above the poverty line and that no vulnerable groups (the elderly, children, disabled people) suffer income deprivation. As society reaches a threshold of basic needs satisfied for the population as a whole, this view says, subsequent inequalities could be considered as largely irrelevant.

The extent to which the reduction of social inequality is a valid additional policy objective (besides poverty reduction) is a complex issue related to at least two considerations: (i) ethical and moral questions of distributive justice; and, (ii) the impact of income inequality on other policy objectives such as sustained economic growth; overall development, socio-political balance and the ability to conduct public policy.

### **II. Theory of Distributive Justice**

The theory of distributive justice<sup>1</sup>, focuses on the causes of inequality, and provides useful philosophical and economic foundations to illuminate discussions on inequality.

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<sup>1</sup> For a recent treatment and review of the theory of distributive justice, see Roemer (1996) and Solimano (1998).

## **2.1 Outside Factors and Personal Responsibility**

If observed, income and wealth inequality reflects, to a large extent, differences in initial endowments of wealth, talent, family connections, race, gender -- most factors beyond the control of the individual or (in philosophical terms), a set of "morally arbitrary" factors -- then inequality becomes an ethical issue as key wealth-creating factors are beyond the control of the individual. However, observed inequality of income, wealth, consumption can and do also reflect individual differences in effort, ambitions and risk-taking. To the extent that these last set of elements reflect personal preferences and belong to the realm of "individual responsibility", they do not, necessarily, constitute an ethical problem from the viewpoint of the theory of distributive justice. This provides an attractive framework to distinguish between equality of outcomes (e.g. income or wealth) and equality of opportunities a subject that we will deal below. This sharp separation between arbitrary and non-arbitrary factors is blurred when it is recognized that "morally arbitrary" factors (e.g. initial wealth and talents) are likely to be related to the formation of preferences and the concept of individual responsibility; two elements that ultimately guide effort levels and the willingness to take risks. In fact, one may think that the perception of a wealthy individual of what constitutes "success in life" (or acceptable levels of welfare) can be very different for the rich than for the poor. This circularity between resources and preferences or between "morally arbitrary factors" and "personal responsibility" makes the theme of social inequality both exciting and overly complex.

## **2.2 Alternative Views**

Fundamentally different visions of society among different schools of thought affect views on inequality<sup>2</sup>. Liberals, Neo-marxists and Libertarians are three main schools of thought in this regard. Liberals such as Rawls emphasizes that initial wealth, family background, social connections and the like can be unfairly distributed at the "birth-lottery". For Rawls the organization of a just society requires a social contract negotiated from a "veil of ignorance" on the distribution of wealth and other traits among individuals that shape their interests in society.

The idea is that a fair social contract must be independent of background conditions, otherwise the rules of the game will be biased in favor of those who are more wealthy in society.

A social arrangement is just for Rawls only if that arrangement is the best for those relatively worse-off in society, compared to other alternative social arrangements; this is called the difference principle<sup>3</sup>.

Utilitarianism and welfare economics provide another analytical base for liberalism, different from the social contractuarism of Locke or Rawls. In contrast to Rawls, utilitarians avoid judging the justice of a given distribution of income and wealth in society. Utilitarians focus only on maximizing the total sum of personal utilities independently on how these utilities are distributed among different members of society. Moreover, welfare economics see distributive outcomes as the result of voluntary wealth accumulation over generations with the remuneration of factors of productions given by productivity and effort levels. This is in contrast with the emphasis given to features (background factors) outside personal control and responsibility, as stressed by Rawls and the theory of distributive justice.

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<sup>2</sup> See Solimano (1998), Chapter 2.

<sup>3</sup> See Rawls (1972).



Another perspective is provided by Neo-marxism. In particular, marxian economics sees unequal property relations and command of productive wealth in capitalism as the main factors in generating and reproducing existing inequalities over time <sup>4</sup>. Neo-marxism eschew the idea of a social contract negotiated from the veil of ignorance. On the contrary, this view stresses that the owners of productive wealth design or influence, at the end, institutions that are functional to their interests rather than to the interests of the less favored in society; hence, the neo-marxian claim of the unfair nature of capitalist society. In contrast, Libertarians as Robert Nozick for example, see the possession of wealth and the right to enjoy its benefits, as a natural right of the individual, and part of their "self-ownership" that includes the right of private use of productive assets and natural resources <sup>5</sup>. Libertarians propose a "minimal state" devoid of powers of taxation that expropriate the fruits of individual effort and risk-taking.

### **2.3 Concepts of Equality**

An important issue relates to the relevant concept of equality<sup>6</sup>. A crucial distinction was made between equality of opportunities and equality of outcomes; as we mentioned already a person might not be responsible for the set of opportunities he (or she) faces when he (or she) is born: race, gender, talent, wealth, family background are all predetermined variables for the individual. However, the individual is responsible to transform favorable opportunities into positive outcomes. Equality in access to wealth-creating factors (e.g. education, credit) is termed equality of opportunities. This would be a valid policy objective from the viewpoint of distributive justice. In contrast, setting the objective of distributive justice in terms of equality of

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<sup>4</sup> Marx (1875, 1970).

<sup>5</sup> Cohen (1995).

<sup>6</sup> An influential discussion in philosophical economics on this subject appears in Dworkin (1981).

outcomes, measured by income or wealth, should not necessarily be a target for social policies, provided outcomes depend, to a considerable extent, on voluntary choices regarding effort in the workplace and/or risk-taking attitudes in undertaking entrepreneurial activities.

Making equality of opportunities as the only valid criteria for social policy circumvents the fact that effort and risk taking are not fully independent of initial background conditions as mentioned before. A more "activist" view of equality would qualify the equality of opportunities, and expand the concept in several directions: First, it would distinguish between formal and effective equality of opportunities (e.g. education might be an universal right in a country, but its effective access may depend on the income level of the student); second, it would call for compensation of those relatively less lucky at the "birth-lottery" (for less talent, for race and gender, subject to discrimination). The implementation of compensation schemes will entail policies of income transfers, affirmative actions and others that go beyond pursuing only equality of opportunities that equalize access to education, capital but that do not compensate for other background conditions that are important for future individual success in life<sup>7</sup>.

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<sup>7</sup> A full discussion of these issues can be found in Roemer (1998).

**BOX 1. Determinants of Income/Wealth and Concepts of Equality**

Determinants of Income and wealth Concept of Equality	Initial assets, talent, gender race, family status ("outside" factors)	Effort levels, risk-taking entrepreneurial capacities (Personal Responsibility)
Equality of opportunities	X (Main here)	
Equality of opportunities	X (Focus here)	X (Focus here)

### **III. Inequality, Growth and Development: Complementarities and Trade-offs<sup>8</sup>**

Let's move from the (complicated) questions of distributive justice to the macro interactions (trade-offs and/or complementarities) between inequality, economic growth, and long-run development. Is income and wealth inequality the price to be paid for accelerated economic growth? Or, conversely, does inequality retards economic growth? How do inequality evolves during the course of economic development? These are key questions that need to be addressed.

#### **3.1 Growth and Inequality Links**

The relationship between economic growth and social inequality at macro level depends on how the growth process is specified<sup>9</sup>. In models of saving-driven growth, if profits-recipients save in greater proportion than wage-earners (linear saving functions), a pattern of income distribution more concentrated towards capital will increase national savings and accelerate the rate of economic growth (all what is saved is invested). This model supported the "conservative" notion that a more equitable distribution of income retards economic growth through a negative effect on the national savings ratio; pointing, then, the existence of a trade-off between growth and equity.

Conversely, neo-Keynesian and endogenous growth theories view growth mainly as an investment-driven process and emphasize complementarities between growth and social equality. In Neokeynesian models in which aggregate demand plays a role in the determination of long-

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<sup>8</sup> This section draws on Ch. 1 and Ch. 4, Solimano (1998).

<sup>9</sup> See Solimano (1996).

run growth, income distribution affects growth through both effective demand (consumption, investment demand, exports) and the rate of creation of new productive capacity.

A redistribution of income to wage-earners can rise aggregate demand and growth in the short-term provided positive consumption effects are dominant over adverse investment and export effects. However, that initial increase in aggregate demand will reach supply constraints, generating inflationary and balance of payments disequilibria that will limit or simply revert initial income redistribution<sup>10</sup>. In the endogenous growth literature, countries with large personal income and wealth inequalities invite, through a political mechanism, higher taxation and the adoption of redistributive policies that depress the profitability of capital, hampering investment, and slowing-down output growth. The main implication here is that initial inequality is bad for subsequent growth. Other channels have also been highlighted to show a negative correlation between personal income inequality and economic growth, wealth and income: inequality can lead to socio-political instability and/or to populist economic policies that are ultimately destabilizing and hamper private capital formation and economic growth. The new literature combines investment driven growth with a political mechanism transmitting public preferences for pro-growth versus pro-redistribution policies into actual government policies. The political mechanism range from elections or referendums to social pressure (e.g. social activism, strikes, etc.). The causality goes from initial inequality to future growth. Interestingly, this literature carries a "progressive" message that social inequality is bad for growth, although identify

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<sup>10</sup> This was the case of the redistributive policies pursued by Allende in Chile in the early 1970s, in Nicaragua in the early 1980s, and in Perú in the mid-1980s.

redistributive policies (particularly those that hamper investment) as the cause why initial inequality brings subsequent slower growth.

Models/Theories	MODEL CLOSURE		ECONOMIC MECHANISM		SOCIO-POLITICAL MECHANISM		CAUSALITY		TYPE OF RELATIONSHIP INEQUALITY/GROWTH	
	Saving Driving Growth	Investment Driven Growth	Through Classic Saving Function	Through Profitability and Investment	Median Votar	Bargaining Power Capitalist Workers	Income Distribution	Growth to Income Distribution	Inverse	Direct
Classic	X		X				X			X
Solow	X							X		
Kaldor		X	X					X		X
New Growth Theory/Endogenous Policy		X		X	X		X		X	
Wage-led and Profit-led Growth Theories		X		X		X	X		?	
Neo-Marxian Theories a) Long-run	X		X			X	X			X
b) Profits Squeeze/Social Structures of Accumuation		X		X		X	X			X

Fuente: A. Solimano (1998)

### **3.2 Empirical Evidence**

The empirics of this inequality-growth literature is largely dominated by cross section or panel regression analysis<sup>11</sup>. In general, several empirical studies tend to support the hypothesis that inequality (an explanatory variable) has a negative, often statistically significant, effect on the rate of output growth (the dependent variable in the regressions) after controlling by variables such as initial per capita income, levels of education, and political participation. This result seems to hold for separate samples of developed and less developed economies (see Persson and Tabellini, 1994) and is robust to alternative functional forms of the distribution-growth relationship and different measures of inequality (share of top quintil, Gini coefficient, Theil coefficient, see Clarke 1992). However, not all studies agree on this. For example, Fishlow (1995) shows that the negative correlation between inequality and growth fails to be detected when a dummy for Latin America, a region with high inequality, is included in the regressions. The influence of the political regime (democracies or non-democracies) on the inequality and growth nexus seems less on agreement. While Persson and Tabellini (1994) found that the negative relationship between inequality and growth holds only for democracies, Clarke (1992) and Alesina and Rodrik, (1994) found no significant impact of the political regime on the sign and significance of the distribution parameter in the growth regressions. It is worth mentioning that all the models tested including the economic and political mechanisms, are reduced forms. A structural test of the political mechanism (median voter) proposed in the theory is hard to find.

A recent World Bank study by Deininger and Squire (1995b) shows that most of the recent test of the negative relationship between initial inequality and subsequent economic growth are based on income distribution data of limited coverage and of little cross-country and

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<sup>11</sup> It is hard to find yet, time-series, historically-oriented, studies of distribution and growth in this literature.



temporal comparability. Moreover, the results obtained in those previous studies have to be carefully interpreted as they are estimates from reduced forms of a structural model in which other variables may determine the joint co-movement of growth and income distribution observed in the data. Moreover, in a related study Liu, Squire, and Zou (1995) using recent and more consistent data on income distribution show that income inequality is relatively stable within countries and over time, in stark contrast with the behavior of the rates of growth of GDP that do change rapidly and are characterized by very low persistence. These two studies strongly caution on the accuracy of the empirical tests of the new growth theory on income inequality.

### **3.3 Inequality and Development Links: The Kuznets Curve**

The relationship between development levels, (proxied by the level of per capita income and income) inequality (measured by the Gini coefficients or the share between top and bottom quintils or decils) postulated by Simon Kuznets have been subject to controversy and empirical testing for a long time. As it is well known, the Kuznets hypothesis states the existence of a non-linear relationship between per capita income and an index of income inequality, reflected in an inverted U-shape curve; income inequality worsens at the initial stages of development, characterized by low per capital income levels, improving thereafter as income per person rises. The Kuznets mechanisms focused on the shift from a surplus-labor agricultural sector paying subsistence wages to a modern industrial sector with higher wages during the initial stages of development. Later on, inequality declines due to a narrowing of wage differentials as the pool of labor surplus is exhausted and the skills profile of the work-force gets upgraded through formal education and learning by doing during the course of development. The causality in Kuznets goes from development levels to inequality, and the sign of the relationship evolves over historical time.

### **3.4 Empirical Evidence**

The Kuznets curve spurred a vast empirical effort devoted at testing its shape, determining its robustness to the selection of countries and time periods, and detecting turning points in which income distribution starts improving along the development process.

The empirical cross section work of Ahluwalia (1976), Lindert and Williamson (1985), Adelman and Robinson (1989), Bourguignon and Morrison (1990) and others tend to give a (qualified) support to the existence of the Kuznets curve. In addition, for cross country regressions, the inequality portion of the Kuznets curve tends to be more unstable than the portion of declining inequality (see figure 1a). Since the inequality part of the curve comprises countries in a range of lower to moderate income per capital levels, the relationship is more unstable for these countries<sup>12</sup>. In contrast, it seems a more established fact that inequality tends to decline for countries at the intermediate and high levels of per-capita income<sup>13</sup> (see figure 1b). However, studies for individual countries in Latin America (Colombia, Brazil, Argentina) and for Asian countries are reported to conform to the Kuznets curve pattern (see Fields and Jakubson, 1993) with a comparison of the impact of inequality on growth in Latin America and East Asia conducted in Birdsall and Sabot (1994).

Two recent World Bank studies (Deininger and Squire, 1995a, 1995b) have produced a new expanded data-base on income distribution of improved coverage and consistency to reevaluate existing studies of the Kuznets curve. These World Bank studies, pooling cross-

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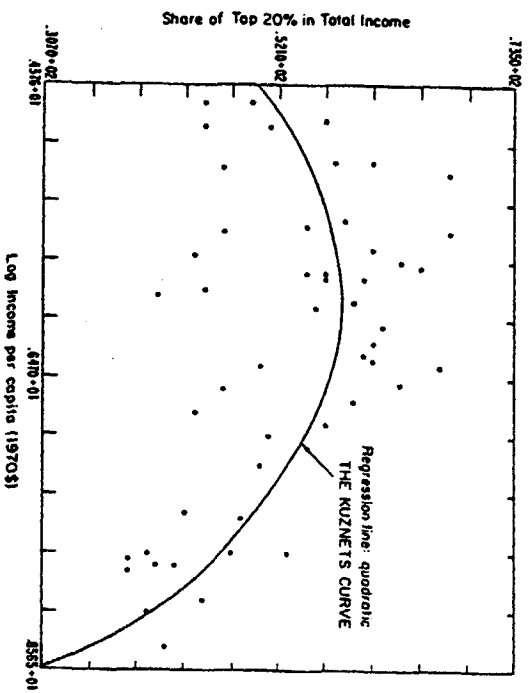
<sup>12</sup> A recent paper, Field and Jakubson (1993), finds a reversal of the Kuznets curve using a "fixed effects" model that allows for different countries to lie on Kuznets curves with the same shape but with different intercepts. However, in pooled models the standard Kuznets curve is maintained.

<sup>13</sup> This does not rule out changes in the levels of inequality even in high per capita income countries as the result of changes in economic policies. This seems to be the case for the US under President Reagan and the UK under Prime Minister Thatcher, in which inequality went up, see Krugman (1993).

section with time series data, show that the Kuznets curve holds only for a very small set of countries (10 percent of the sample) and that in general no statistical significant relationship between the level of income and inequality is found for over 75 percent of the sample. The "universal Kuznets curve" fails to be detected in the data. These recent studies thus, cast doubts on the existence and robustness of the Kuznets curve. More research is needed, to settle the confronting new World Bank and previous evidence on the Kuznets curve. Anyway, there seems to be that as countries move up in the income per-capita ladders, inequality tends to decline. An important practical question is at what levels of per-capita income (US\$5,000?, US\$8,000?) income inequality start declining and how public policies can help accelerate this process.

Figure 1. The Kuznets Curve

1a) Cross Section



# 1b) Time - Series

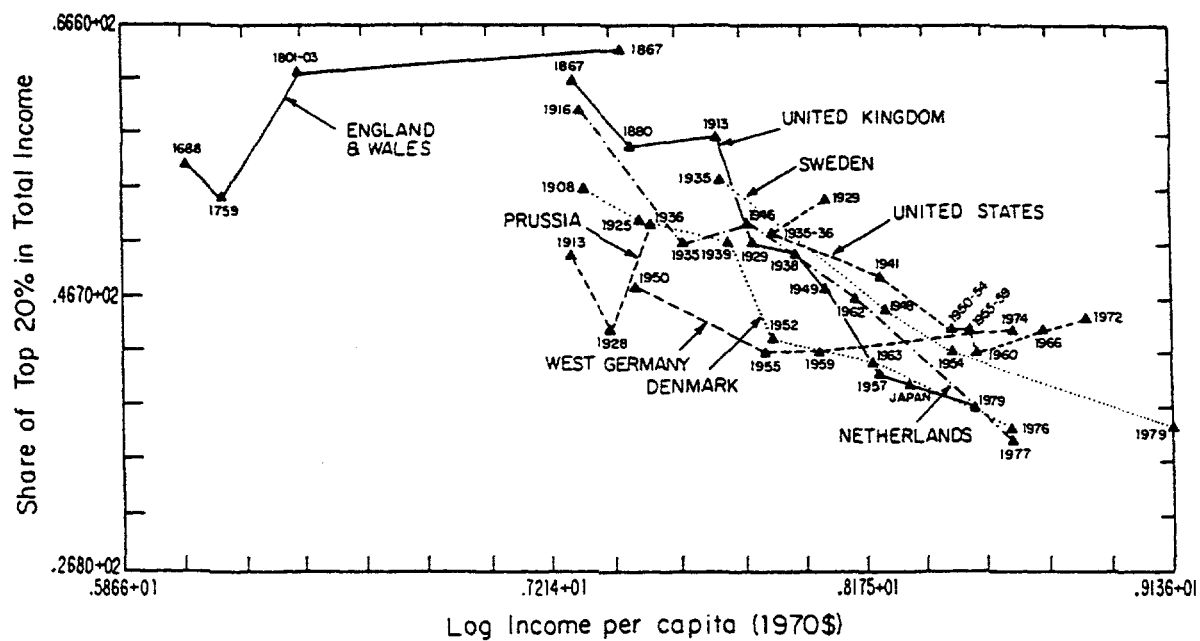


FIG. 2. The Kuznets curve: historical time series from five European countries and America (source: See Appendix).

Source: Lindert and Williamson (1985).

#### **IV. Policy Issues:**

##### **4.1 Growth and Equality. Can they match?**

A central policy question is whether public policies oriented to improve income distribution can be compatible with high and sustained growth? The macro-growth models reviewed here, offer arguments to support either "conservative" views that redistribution deters growth as well as "progressive" views in which redistribution and growth are compatible and, even, mutually reinforcing complementary policy goals. Analytically, the conservative view finds support in two models. In a full-capacity, growing economy, income redistribution to relatively low-savings groups can depress the aggregate savings ratio therefore leading to a decline in growth. In investment-driven models, redistributive policies that entail higher taxation and/or regulation depress privately appropriated returns on human capital and physical investment and harm growth.

Are thus we condemned to accept social inequality as the price for high growth policies? Is the "conservative equilibrium" inescapable? Not necessarily. Three arguments are in order here. First, the message of the Kuznets curve, is that the growth process itself would be "equalizing" beyond certain threshold of income per-capita, (the turning point of the curve), making the fruits of progress and development available to a greater portion of the population. Second, beyond trickle-down, policy intervention in assuring broad-social access to education (and to credit) can have a big pay-off. The market-equilibrium can yield substantial under investment, particular in human capital, for those at the bottom part of the income distribution that cannot pay for their education and face very limited access to capital markets. The rewards in terms of accelerated growth of education-widening are bound to be sizeable. Third, a more equitable distribution of income and economic opportunities also contribute to social peace and

political stability, key ingredients in a policy framework conducive to investment, innovation and growth. Ultimately, social equity and economic growth can go hand with hand if properly articulated to respect some key binding economic and political constraints in society.

#### **4.2 Social policies and the Washington Consensus : Scope and Limits**

In line with market-based economic reform, during the last decade countries have moved away from traditional social policies that often involved across-the-board (to large segments of the population) subsidies on basic food-stuff, public utilities such as water, electricity; besides universal access to education and health services. For a while, in many countries these policies enabled considerable reduction in analphabetism, substantial educational upgrading of the middle class and lower income groups and improvement in health indicators. However, these policies eventually led to a growing fiscal burden and they often benefited also higher income groups. The social policies implicit in the Washington Consensus (in fact this consensus is criticized for the lack of explicit social policies, see Stiglitz, 1998) tailored to a market-based policy framework rest on the following principles:

- Economic growth should be the main engine for poverty reduction and improvement in living standards (the "trickle down" effect).
- Relative prices and the market mechanism must guide resource allocation and the incentives to save and invest. Social policies must avoid affecting the relative price structure of the economy through subsidies and indirect taxation. Price controls of basic food stuff must be eliminated. Marginal cost pricing must dictate user-fees for public utilities.
- Social policies must be explicitly focused on--or targeted to-- the most vulnerable segments of the population (the elderly, children, the handicapped) and the poorest

groups in society (rural population, workers in the informal sector, families in extreme poverty in urban dwellings).

- Private sector participation in the provision and management of basic social services such as education and health must be encouraged through privatization and/or concession schemes.
- The explicit objective of social policy is poverty reduction. Correcting large income or wealth inequalities is not an explicit policy objective.

A full evaluation of the implementation and results of social policies based on these principles is beyond the scope of this chapter but a few observations are in order.

As mentioned above, *economic growth* is seen as the main vehicle for poverty reduction and improvement in living standards. There is no question that economic growth is very important. Growth directly generates employment and real income to labor market participants and provides --through tax receipts-- fiscal revenues to the state to finance social policy. Moreover, a growing economy is bound to ease distributional conflict as competing claims are over a "growing pie" rather than a zero-sum game. However economic growth also presents limitations as a mechanism to enable poverty reduction and improving living standards. First, the potential for poverty-reduction of growth depends not only the level of growth but also its composition: it has to be labor-intensive, and benefit more unskilled labor. The spacial (or regional) composition of production must favor more poorer regions than others. Second, GDP, or any aggregate output measure, is a yardstick that omits distributive consideration<sup>14</sup>. Third, output growth does not directly reach some vulnerable groups such as the elderly, the children, the handicapped, those in rural areas in subsistence agriculture that are outside the labor market

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<sup>14</sup> See Sen (1987) and Anand and Sen (1996).



and form part of the dependent population. Fourth, GDP statistics often under-report informal sector activities in which lower income groups are involved. Family-based or public-based redistribution is thus needed to reach these segments. Fifth, GDP is a commodity or "opulence-based" measure of economic welfare that does not include non-market goods (such as political freedom, the psychological value of belonging to community, etc.) and bads (environmental degradation, crime, urban congestion) that also centrally affect human well-being. Sixth, unlike traditional social policies that had a political constituency in the urban working-class, in the strong unions of the middle class (teachers, doctors) and in other interest groups, the new social policies have as beneficiaries poor and vulnerable groups with a weak voice and feeble political organization; this creates tenuous political incentives for active poverty reduction beyond that provided by economic growth and may be an important factor behind chronic poverty.

Another main piece of the new strategy of social policies is targeting. The emphasis on precisely defining the beneficiary groups is a reaction to social policies that often reached, at a high fiscal cost, the non-poor (the middle class and the rich). A basic principle of targeting is to focus social policy on the poor avoiding reaching the non-poor<sup>15</sup>. In this context, targeting is more effective in terms of reaching the "real" poor, and at a substantially reduced fiscal cost than untargeted, broad-based, social policy.

However targeting is not problem free either. First, targeting makes the beneficiary a passive "victim" rather than an active agent with policy responses and choices<sup>16</sup>. Second, informational and incentives problems are serious. Delimiting the beneficiaries and their poverty features that needs to be addressed is not easy (e.g. an information problem). Reaching with the

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<sup>15</sup> See Cornia and Stewart (1996) on an interesting discussion of two types of "errors" in targeting, the E-error (excessive coverage, e.g. reaching the non-poor) and the F-error (failure to reach to poor).

<sup>16</sup> See Sens (1996) on this.

administrative apparatus of the state the most vulnerable groups cannot be taken for granted everywhere. Moreover, some targeted groups have a more active political voice than others, biasing the transfer of resources to them (e.g. an incentive problem). Political favoritism and clientelism of certain groups can lead to the failure to reach the most needy.

Private-sector provision and delivery of social services such as education and health is another component of a market-based approach to social policy. Private sector involvement in the social sectors can help to release financial and human resources of the state in order to focus its effort on the lower income groups. Privatization of social services seems to work well in terms of an adequate provision -- in terms of quantity and quality-- of education and health services for high income and the upper middle class that can afford to pay for the services privately provided. However, for low income groups and segments of the middle class the situation is different. As their ability to pay is low they depend on demand subsidies--e.g. a voucher system-- for getting access to high-cost, privately-provided social services or else they have to be served by the state. In addition, in the case of private health systems, providers often put clauses that exclude the elderly , the chronically ill and those with large families from access to these programs. Nevertheless, these are precisely the most vulnerable groups that need most protection.

The co-existence of a system of relatively poor state-provided education and health system along with a modern and affluent private system, creates serious incentives and equity problems. School teachers, university professors, physicians and paramedicals often have considerable incentives to work in the high paid, private sector, decapitalizing the state-sector. Moreover, while some citizens will have access to first-class education and health services, others will face impoverished, education, and health services provided by the state. A main

challenge is how to guarantee good quality, cost-efficient, social services for the large groups segments of the population that cannot afford to pay for the services delivered in the private system and that therefore have to be served by the state.

#### **4.3 Policies to Match Growth, Social Equity and Poverty Reduction.**

Policies oriented to increase individual productivity and earning capacities are crucial to match economic growth with a better income distribution and less poverty. Education is a clear case; it endows people with greater human capital and promotes social mobility.

It matters also the quality of education and the extent to which the poor has access to it. However, education is a supply side policy that, to be effective, requires a corresponding level of demand for human resources, which in turn depends on the level of effective demand and the pace of growth. A bad equilibrium is to have pools of educated and well-qualified people that is unemployed or underemployed.

Health-related policies are also essential for building up human capital. An improvement in health capacities reduce people's vulnerabilities and boost the quality of life.

Broadening and democratizing the access to credit is also an equalizing, productivity-enhancing mechanism as many latent productive projects identified and developed by small scale entrepreneurs and households fail to be implemented by lack of credit and finance. Policies of asset distribution regarding land reform and broad-based ownership of productive capital, say after privatization, are also worth considering.

The recent literature on "inequality harms growth" stresses that redistributive policies penalize private investment and growth. This calls attention on how redistribution is carried out. Capital taxation can depress profits rates and lead to slower investment; the level of taxation has

to be monitored as high taxation invite evasion besides hampering savings, investment, and growth. However, investment is also very sensitive to uncertainty and socio-political instability.

In that perspective, policies oriented to reduce large social inequalities can have a significant "social-peace dividend" that is essential to foster a framework conducive to investment and growth.

The promotion of economic growth as a basic engine for better living standards and poverty reduction has to be maintained, but complemented with a greater awareness of the limits of commodity-based welfare. A healthy physical environment, economical and physical security, civic participation and political freedom are all very important dimensions of meaningful human self-realization beyond the consumption of goods and services.

In addition, paternalistic social policies have to be avoided. This is a defect of both traditional social policies with broad-based subsidization and also of targeting and its passive approach of unreactive beneficiaries. A web of community and non-governmental organizations that have appeared in recent years in many countries are a useful bridge between individual atomization and the state (with its limited administrative and financial capacities). These intermediate organizations can and do play an important role in the design and management of social policy.

Private provision of some social services can serve an useful role for higher income groups. It can be also a source of innovation and best practice that should permeate state-based provision of social services. In developing countries it is clear that the vast majority of the population needs access to either subsidized or state provided education and health services. How the two systems can co-exist and how to improve the quality of the services provided by the state are important open questions.

Finally, most of these policies can be termed as “structural social policies” envisaged in the framework of a growing economy. The situation is different when macroeconomic crisis lead to higher unemployment, decline in real wages and incomes, particularly for the poor and vulnerable. In this case social safety nets are needed. The institutional and financial requirements of putting in place emergency social problems are often less burdensome than those of structural social policies. Social safety nets often involve the provision of emergency employment to those that lose jobs after fiscal retrenchment, the delivery of food and medicines to children in schools and guarantee minimum income support, among other policies.

### **Concluding Remarks**

Some of the main topics and conclusions of this chapter can be summarized as follows:

- Social policies in developing countries in the last decade or so have been defined almost exclusively in terms of poverty reduction. A fresh look at the issue of income distribution and the reduction of social inequality as valid policy targets beyond, simply, poverty reduction is needed.
- The modern theory of distributive justice distinguishes between "outside" or morally arbitrary factors (gender, race, initial assets, talent) and "personal responsibility" elements (effort, risk-taking attitudes) in shaping the level of income, wealth and welfare of the individual in society. Social inequality is a reflection of individual differences in these two set of wealth-creating factors.
- Any meaningful social policy needs defining a concept of equality. Equality of opportunities (e.g. to education, to bank credit) to be effective, rather than formal, needs some complementary actions. Further concepts such as equality of outcomes calls for

compensating mechanisms for poor endowments of useful traits (e.g. talent, gender) at the "birth-lottery".

- The new theories of endogenous growth stress the existence of complementarities between social equity and growth. Provided that inequality engender social conflict, invite taxation of physical investment and induce economic populism, we can conclude that social inequality hampers economic growth. The empirical evidence based on time series and cross section seems to support, with qualifications, the adverse effect of inequality on growth.
- The Kuznets curve, linking development levels and income distribution suggests a trend towards lower inequality after "intermediate" levels of per-capita income have been reached. Assuming that the Kuznets curve holds, something in dispute now, it is important to know plausible levels of per-capita income for which a decline in inequality is to be expected and the mechanisms that bring about that decline.
- The "Washington Consensus" has supported social policies that rely on three main pillars: growth-led poverty reduction, targeting, and private sector participation in the delivery of social services. Some loose ends of this strategy are: a) biased growth patterns in favor of skilled labor and non-labor factors of production, b) exclusion of vulnerable groups that do not derive income from the market process, c) excessive reliance on commodity-based growth for human development that encompass also environmental considerations, civic participation in public decision-making and grass-roots democracy, d) political manipulation of beneficiaries and weak institutional capacities to reach targeted groups, e) excessive differences in the quality of the social services provided by the private sector and received by high income groups (and the upper middle class)

compared to the modest or poor quality of social services delivered by the state and received by low income groups.

- A catalog of structural social policies oriented to promote equitable development must include the provision of broad based, good quality education and health services, broader access to credit by low-income households and small scale producers, and egalitarian access to land and ownership of the capital stock (say after privatization).
- Social safety nets are needed in periods of macroeconomic crisis leading to high unemployment, cuts in real wages and decline in real incomes of the poor. The social safety nets may comprise policies such as emergency employment programs, food distribution to children and vulnerable groups and schemes of minimum income support. Austerity programs without social safety nets impose undue costs to the poor, the vulnerable and the politically weak, making fiscal retrenchment difficult to implement and socially regressive.

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